INITIAL STATEMENT OF REASONS
NON-CONTROLLING SUMMARY

PROPOSED REGULATIONS 1125 AND 1423, TWO-PARTY EXCHANGE, AND
PROPOSED AMENDMENTS TO REGULATIONS 1123 AND 1420, SUPPLIER

Regulations 1125 and 1423 are proposed to explain the requirements and conditions which must be met before the State Board of Equalization (Board) will permit the primary liability for motor vehicle fuel tax and diesel fuel tax, respectively, to be transferred from the delivering supplier to the receiving supplier under a two-party exchange of fuel and to provide definitions of relevant terms. Amendments to Regulations 1123 and 1420 are proposed to clarify that the primary liability for fuel tax will remain with the delivering supplier if the requirements of Regulations 1125 and 1423, respectively, are not met.

Specific Purpose

The purpose of proposed Regulation 1125 is to interpret, implement, and make specific Revenue and Taxation Code section 7372 of the Motor Vehicle Fuel Tax Law. The purpose of proposed Regulation 1423 is to interpret, implement, and make specific Revenue and Taxation Code section 60063 of the Diesel Fuel Tax Law. These regulations are necessary to provide guidance to taxpayers affected by these statutes. The purpose of the proposed amendments to Regulations 1123 and 1420 is to address the effects of proposed Regulations 1125 and 1423, respectively, on the existing regulations.

Factual Basis

Proposed Regulations 1125 and 1423 provide a description of a two-party exchange and relevant definitions and discuss the requirements and conditions that must be met for the primary liability for fuel taxes to be transferred from the delivering supplier to the receiving supplier pursuant to a two-party exchange. Regulation 1125 addresses a two-party exchange with respect to the Motor Vehicle Fuel (MVF) Tax Law, and Regulation 1143 addresses a two-party exchange with respect to the Diesel Fuel Tax Law. Otherwise, they are textually identical, as are the proposed amendments to Regulations 1123 and 1420.

The Board is proposing Regulations 1125 and 1423 for the following reasons. Current MVF and Diesel Fuel Tax Laws impose a fuel tax on the removal of motor vehicle fuel and diesel fuel from a terminal or refinery rack. The supplier (position holder or refiner)[1] is liable for the payment of MVF tax and diesel fuel tax to the State. However, both fuel tax laws, under Revenue and Taxation Code sections 7372 and 60063, respectively, permit the Board to accept payment of the fuel taxes from the person who receives the motor vehicle fuel or diesel fuel at the terminal or refinery rack in a two-party exchange, if the Internal Revenue Service (IRS) authorizes payment of federal fuel taxes by the receiving party under a two-party exchange contract or agreement. The supplier remains primarily liable for the fuel tax until the fuel tax is paid and credited to the account of the supplier.

[1] See Revenue and Taxation Code sections 7372, 7334, and 7338 (60010, 60011, and 60033).

The Board may, however, relieve the supplier from primary liability and hold another person primarily liable for payment of the tax if the IRS has authorized the receiving party to pay the federal fuel tax, if the IRS has made another person primarily liable for payment of the tax, and if the Board elects to follow the IRS approach of accepting fuel tax from the receiving party under a two-party exchange contract.

The federal American Jobs Creation Act of 2004 authorized the IRS to receive payment of federal fuel taxes from the receiving party under a two-party exchange contract and made the receiving party primarily liable for the federal fuel tax.

Western States Petroleum Association (WSPA) requested that the Board make the election to follow the IRS approach. WSPA requested that the Board permit the receiving party under a two-party exchange contract to become the primary taxpayer for payment of the California fuel taxes collected at the terminal or refinery rack. Election of this approach would allow suppliers and terminal operators to report taxable transactions in the same manner to both the IRS and the Board. Other states that impose a fuel tax at the terminal rack have successfully implemented the two-party exchange.

Proposed Regulations 1123 and 1420 are the result of the Board's election to follow the IRS approach. These regulations provide, in subdivision (a), a general description of a two-party exchange, the reasons for a two-party exchange, and an explanation that fuel subject to the exchange may be held in terminals located in one or more states and may include more than one fuel type and that only the transactions involving terminals located in this state should be reported to the Board.

Since "two-party exchange" is not defined in the MVF or Diesel Fuel Tax Laws, subdivision (b)(1) in the proposed regulations defines a "two-party exchange." Subparagraphs (1)(A) through (1)(D) of subdivision (b) explain the conditions for a transaction to qualify as a two-party exchange. The term "delivering supplier" is defined in subdivision (b)(2), and the term "receiving supplier" is defined in subdivision (b)(3).

Further, since, under circumstances other than those involving a two-party exchange, the supplier who is a refiner or who holds an inventory position in fuel at the terminal is primarily liable for the tax at the time the fuel is removed from the rack, the regulations explain, in subdivision (c)(1), that, when a transaction satisfies the conditions and requirements of a two-party exchange contract, the delivering supplier shall be relieved of the fuel tax liability and the receiving supplier shall be liable for payment of the tax. Subdivision (c)(2) explains that the receiving supplier must report the two-party exchange and remit the tax on a tax return filed within three months after the close of the calendar month in which the fuel was received. The second sentence clarifies that a receiving supplier can receive a refund of any overpayment of fuel tax. The third sentence clarifies that, when all the parties report a transaction as a two-party exchange to the Board, the transaction may not be reversed nor may the taxes be refunded to the receiving supplier. Subdivision (c)(3) clarifies that, if the receiving supplier fails to report or remit the tax on a two-party exchange, the delivering supplier shall remain primarily liable for the taxes due on the removal of fuel from the rack.

Subdivision (d) of the proposed regulations explains the general reporting requirements of the terminal operator, delivering supplier, and receiving supplier, and subdivision (e) explains the reporting requirements for delivering and receiving suppliers that must be met in order for an exchange of fuel to qualify as a two-party exchange and shift the imposition of fuel tax liability to the receiving supplier. Paragraphs (1) through (4) of subdivision (e) clarify what must be reported. Subdivision (f) establishes an operative date of January 1, 2007, for the proposed regulations.

Amendments to Regulations 1123 and 1420 are proposed to add subparagraphs (3)(C) and (4)(D) to subdivision (b) to clarify that the position holder or refiner, respectively, delivering fuel to a receiving supplier under a two-party exchange contract remains liable for the tax unless all the requirements of the two-party exchange regulation are met and to establish an operative date.

Pursuant to Government Code section 11346.2, subdivision (b)(3), the only reasonable alternative to promulgating proposed Regulations 1125 and 1423 was to not promulgate these regulations. Although the regulations impose minor additional record keeping responsibilities on small businesses such as terminal operators, these additional responsibilities are offset by the advantages gained by conforming the two-party exchange process in California with the two-party exchange process in other states and with the Internal Revenue Service. The fuel industry, including the position holders, refiners, and terminal operators, supports adoption of these regulations. No other private businesses or persons will be affected by these regulations.

Pursuant to Government Code section 11346.2, subdivision (b)(4), the Board has determined that adoption of the proposed regulations will not have a significant adverse economic impact on private business or persons. The regulations are proposed to interpret, implement, and make specific the authorizing statutes. These regulations and amendments will clarify the interpretation and administration of a two-party exchange under the MVF and Diesel Fuel Tax Laws. Therefore, the Board has determined that these regulations and amendments should be adopted.